Economic Update

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Volume 4, Number 3

15 April 2005

Outlook for Growth Continues, But Concerns Rise

The U.S. economy is growing at a solid pace with low unemployment, inflation and interest rates – and forecasters expect non-inflationary real growth to continue.

The recent performance of the economy is generating concern about stresses associated with increasing demand on resources – rising oil prices and growing inflationary pressures are examples – as well as other emerging imbalances. In general, however, the adverse effects from these factors do not appear to be of sufficient magnitude to threaten the overall outlook for continued expansion. Nevertheless, how they are resolved could have important effects on economic performance.

Situation and Outlook

Key indicators continue to show solid growth spread across major sectors of the economy.

- Real gross domestic product [GDP] grew 3.8 percent at an annual rate in the fourth quarter of last year according to the "final" estimates for that quarter. For the full year of 2004, real GDP growth increased at a 4.4 percent rate, the strongest growth in 5 years and one of the best performances in two decades.

- Last month's 110,000-job increase in nonfarm payroll employment – somewhat lower than expected – nevertheless brought to 3.1 million the total increase in jobs in the past 22 months. The unemployment rate fell to 5.2 percent in March, down from 5.4 percent in February.

- Housing starts rose to a pace of nearly 2.2 million units at an annual rate in February, continuing the strong activity of the past year and a half and the best sustained performance since 1978. Sales of new and existing single family houses over the past year have been at a record-high level.

- Industrial production – the output of the Nation's factories, mines, and utilities – rose by 3.9 percent over the past year, and by 6.4 percent over the past year and a half. Manufacturing industrial production has been a bit stronger, rising by 4.1 percent over the past year and 7.1 percent over the past year and a half. But the growth of manufacturing activity (as measured by the Institute for Supply Management's purchasing managers index) has slowed in recent months.

- Real consumer spending rose 3.8 percent at an annual rate over the past 2 years, and real business equipment and software spending increased at a 13 percent rate.

- The Blue Chip "consensus" projection – the average of 50 private sector forecasts – shows that real GDP is expected to increase by about 3.6 percent during 2005 and by 3.3 percent during 2006. Consumer price index [CPI] inflation is expected to be temporarily higher in the second quarter of this year, but then settle down to just below 2½ percent. Interest rates are expected to rise gradually through the end of next year.

Blue Chip Economic Outlook, April 2005

	2004.4	2005.1	2005.2	2005.3	2005.4	2006.1	2006.2	2006.3	2006.4
	Actual	----------	----------	*Projection*	----------	----------	----------	----------	----------
Real GDP Growth	3.8	3.9	3.6	3.5	3.3	3.3	3.3	3.3	3.3
Unemployment Rate	5.4	5.3	5.2	5.2	5.1	5.1	5.1	5.0	5.0
CPI Inflation	3.4	2.3	2.7	2.2	2.3	2.4	2.5	2.4	2.4
3-month Treasury Bill	2.0	2.5	3.1	3.4	3.7	3.9	4.0	4.1	4.2
10-year Treasury Note	4.2	4.3	4.6	4.8	5.0	5.2	5.2	5.3	5.3

Note: Unemployment and interest rate values for 2005.1 are actual values.

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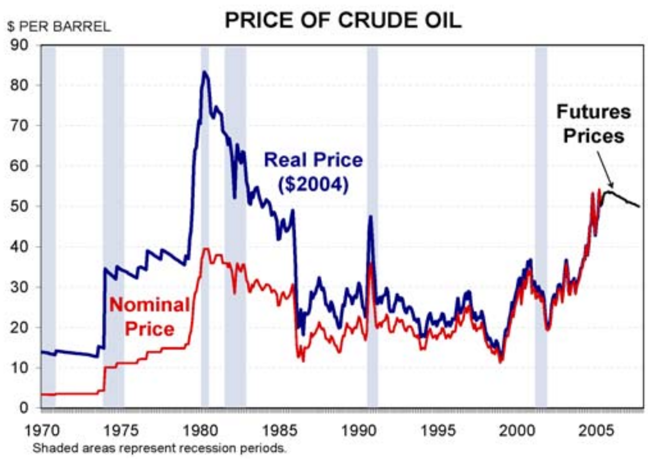
Looming Issues

During the recovery following the 2001 recession, underemployment of resources and even deflationary pressures were primary issues. In contrast, in an expansion phase such as the current one – with the economy approaching full employment – attention often shifts toward issues related to higher demand for primary resources, potential inflationary pressures, increased awareness of ongoing imbalances, and policy efforts to promote continued real growth with low inflation. Current issues include:

- *The price of crude oil* (West Texas Intermediate) has been high and volatile, recently exceeding $55 per barrel. Even with the rise to record *nominal* levels, in real, inflation-adjusted prices, the current price of crude oil is similar to what occurred in the early to mid-1980s and is well below the highs of the 1979-82 period. Still, oil prices in real terms are the highest in 20 years. Futures markets data suggest that prices near or in excess of $50 per barrel could persist for years to come. Gasoline prices reflect the increase in oil prices: the national average retail price for regular gasoline reached $2.28 per gallon in the week ending April 11, up from $1.65 a year earlier; in California the price hit $2.59 per gallon.



- *Inflation and Fed policy*: Analysts see a greater likelihood of higher inflation, raising concerns about the outlook for Federal Reserve monetary policy. Eighty-eight percent of the Blue Chip private forecasters "believe that inflation is more likely to surprise on the upside [than on the] downside this year." Also, the Federal Reserve's policy group, the Federal Open Market Committee [FOMC], reported in its March policy statement: "Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident."

- *Consumer confidence* and sentiment have shown little or no improvement over the past year, and there are concerns that rising gasoline and energy prices, and risks of higher inflation, are damping consumer attitudes. Consumers' gasoline spending increased sharply in March, but other retail sales were disappointing. Consumer sentiment slipped in the first half of April – the fourth consecutive monthly decline – to its lowest level in a year and a half.

- *The U.S. international trade deficit* is setting new record highs both in nominal dollars and relative to GDP. In 2004, the U.S. deficit in international trade in goods and services reached $617 billion, more than 5 percent of GDP. This compares with the $108-billion figure in 1997, about 1¼ percent of GDP. A significant contributor is strong U.S. economic growth, which boosts imports and attracts investment. For the 1997-2004 period, U.S. real GDP growth averaged 3.4 percent, but European countries of the "Euro area" grew an average of only 2.1 percent; and Japan averaged only a 1.3 percent rate. (If the U.S. had grown as slowly as Japan, U.S. real GDP in 2004 would have been $1.6 trillion lower – about a 15 percent reduction in size.) In addition, the artificially low value of the Chinese currency (and other East Asian currencies) keeps the purchasing power of the U.S. dollar high relative to those currencies, and keeps the cost of their export goods relatively low for U.S. importers.

- *The fiscal policy outlook* and projections of the Federal budget deficit – especially the magnitudes relative to the size of the economy – also affect the economic outlook. The President and Congress have made budget proposals for reducing the budget deficit as a share of GDP over the next 5 years.

Some other factors – including retirement and pension costs and medical costs – also raise concerns, but likely more for the long-term outlook. In general, the likely effects of the concerns addressed here do not appear to be of sufficient magnitude to be imminent threats to derailing the U.S. economic expansion, but how they eventually are resolved may have significant effects on economic performance.

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